

Testimony of

Harris H. Simmons

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Committee on Financial Services

United States House of Representatives

September 14, 2006



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Mr. Chairman and members of the Subcommittee, my name is Harris Simmons. I am Chairman, President and Chief Executive Officer of Zions Bancorporation, and Chairman of Zions First National Bank, both of which are headquartered in Salt Lake City, Utah. I also serve as Chairman of the American Bankers Association (“ABA”), and am here today to testify on behalf of the ABA.

ABA, on behalf of the more than two million men and women who work in the nation’s banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA’s views regarding the ongoing efforts to implement the Basel II risk-based capital requirements, and regarding the proposed guidance concerning commercial real estate (“CRE”) concentrations. The ABA appreciates Congressional oversight of the regulators’ actions in both of these important areas. Recent proposals by the regulators, while well-intended, have the potential to reduce the availability of affordable credit, adversely affect competition among banks, increase risk, and add to the already heavy costs of compliance.

RISK-BASED CAPITAL STANDARDS—SUMMARY

The ABA has long supported a comprehensive approach to the regulation of risk-based capital that encompasses minimum capital requirements, supervisory review, and market discipline. The goal of the Basel II accord is to arrive at capital requirements that better reflect risk in a bank. However, the Basel II capital requirements as embodied in the banking agencies’ (“Agencies”) recently promulgated Notice of

Proposed Rulemaking (“Proposal” or “NPR”) fall short of that mark. In my testimony concerning the capital rules I would like to make the following points:

- First, the advanced capital adequacy framework recently proposed by the Agencies is an inappropriately conservative implementation of the international Basel II accord that would place U.S. banks at a competitive disadvantage with banks in other countries and impose a suboptimal use of financial resources.
- Second, the Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.
- Third, the variety and complexity of the American banking industry call for a select menu of capital options in order to achieve the best match of effective capital standard with banking institution; a one-size-fits-all approach means a bad fit for most banks.

CRE GUIDANCE—SUMMARY

Turning to the guidance concerning CRE concentrations, imposition of an industry-wide guidance in response to concentrations that are occurring at only some banks may negatively impact the free flow of credit from all banks that engage in CRE lending in a safe and sound manner. In my statement today I would like to make the following points regarding the CRE guidance:

- First, blanket industry-wide CRE guidance is unnecessary and potentially harmful.
- Second, if the Agencies conclude that guidance on CRE concentrations is necessary, several changes should be made in order to avoid unintended negative consequences.
- Third, if applied, the guidance should be used as a tool to identify the need for further inquiry, not as a formula for increased capital and reserves.

The above points concerning Basel II and the CRE guidance are discussed in further detail below.

RISK-BASED CAPITAL STANDARDS

I. The Agencies are Diverging from the Basel II Standards to the Detriment of U.S. Banks.

The Agencies have chosen a more restrictive and prescriptive approach than that being implemented in other countries. The provisions to be applied to internationally active U.S. banks, along with additional limitations that slow implementation and prevent efficient allocation of bank capital, mark a divergence from the standards embodied in the internationally agreed upon Basel II accord.

Under the international accord, three options for approaching credit risk are permitted. These include the Standardized Approach, the Foundation Internal Ratings-Based Approach, and the Advanced Internal Ratings-Based (“AIRB”) Approach. In the U.S., the Agencies have proposed rules that implement *only the AIRB approach*, requiring the largest internationally active banks – the so-called “mandatory banks” – to abide by them.

The Agencies propose to implement the AIRB approach in ways that are more restrictive than those embodied in the international Basel II accord. For example, the Proposal requires a bank that sells loans from a single borrower at a discount of five percent or more to treat *all* other loans from the same borrower as being in default, regardless of the situation. Other international banks lending to the same borrower would *not* be subject to the same requirement. Not only does such provision create artificial differences among competing institutions, it also contradicts the intent of the AIRB approach under Basel II, which is to allow banks the freedom to develop their own internal ratings-based system.

Furthermore, the AIRB approach as proposed contains several limits that will prevent banks from realizing its potential benefits. These limits include the following:

- Retention of the leverage ratio, which is currently the binding constraint on mandatory banks with respect to minimum capital requirements. Implementing the AIRB approach, while simultaneously retaining the leverage ratio, will render AIRB minimum capital determinations meaningless at best and harmful at worst. Banks that are required to hold more capital than is justified by a risk analysis will have incentives to take additional risks, perhaps outside their areas of expertise, in order to earn an acceptable return on the excess capital.

- Phasing in the AIRB approach over a three-year period following implementation of the Basel II standards. U.S. banks will be limited during this phase-in period by “transition floors” that impose arbitrary minimum capital requirements. No other Basel II nation will employ such limitations, and banks around the world will have moved on to the AIRB system long before U.S. banks even begin.
- The Agencies’ promise to make further adjustments to the capital rules if the aggregate capital of banks employing the AIRB approach decreases more than ten percent during the phase-in period. This would effectively guarantee that the benefits of the AIRB approach will not be realized.

The objective of the rulemaking should be to tie capital to risk. Banks do this every day, separate and apart from regulatory capital requirements. Mandatory banks will continue to base their business decisions on their own internal measurement systems. However, if regulatory constraints interfere with this process and impose less accurate requirements, most banks will be forced to run parallel systems. One system will be used to satisfy the regulator, while the other system – which is a better gauge of risk – will be used to run the bank. It will be disruptive and inefficient to operate in an environment of dueling capital standards.

As a result of what some have called the “cumulative conservatism” of the AIRB approach as proposed in the NPR, the industry is likely to realize few, if any, of the benefits that were anticipated at the inauguration of the Basel II exercise as offsetting the burdens of the more complex rule. Artificially high capital requirements, coupled with a costly compliance burden, likely will lead to one of three results. Some domestic banks will choose to shift operations abroad as much as possible in an attempt to use their capital more efficiently, reduce their compliance burden, and continue to offer the best prices possible for their services. Others will choose to comply with the U.S. rules and, as a result, labor under the burdens of unnecessary costs and inefficient use of capital. There will be a third group of banks, however, that will comply with the U.S. rules but take on riskier lines of business to optimize the capital that they are required to hold. Each of these outcomes is likely to cause the U.S. economy to suffer. By being too restrictive, the Agencies would effectively impose a regulatory tax that either would make U.S. banks less able to serve as an economic catalyst in the United States or prompt them to engage in inappropriate risk-taking solely to use the excess capital required by the regulation.

The adverse consequences of the AIRB as proposed in the NPR are not confined to the mandatory banks. A bank considering whether to “opt in” to the adoption of the proposed AIRB likely

would find the benefits far outweighed by its burdens. Hence, the Basel II goal of encouraging superior risk management will be undermined.

These detrimental effects of the AIRB as proposed can be avoided if the Agencies adopt instead an AIRB that more closely follows the international Basel II accord. By making the capital rules that apply to U.S. banks comparable to those adopted in other countries, the competitive disadvantages that are hardwired into the current U.S. proposal would disappear, and banks domestically would have regulatory capital that is a much better match for their risks.

II. The Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.

If the Agencies were to adopt advanced capital rules comparable to those of the international Basel II accord, this would result in lower capital charges in many instances for the mandatory banks and opt-in banks (collectively, “Basel II banks”). Taken by itself, however, that would leave much of the rest of the banking industry subject to admittedly out-of-date capital standards. As a result, the vast majority of U.S. banks could find themselves at a disadvantage when competing with a Basel II bank for a particular asset. Evidence from the Quantitative Impact Studies indicates that Basel II banks could have significantly lower risk-based capital requirements for good credits, even after accounting for operational and other risks. Such banks would be able to make the same loan as community and regional banks, but at a fraction of the risk-based capital assessment. This would allow a Basel II bank to compete more aggressively for a given asset and it would free up capital for such banks that may be used to acquire more assets.

It is imperative that the Agencies not create winners and losers based on how much capital a given bank must set aside for a particular asset. To maintain competitive balance within the American banking industry, an appropriate update of capital rules is needed for all the community and regional banks for which the more advanced elements of Basel II are excessively expensive and complex. Each of these rules should require roughly the same amount of capital for the same asset, regardless of the size or sophistication of the banks involved.

The original Basel Accord was developed more than fifteen years ago to provide a uniform international regulatory standard specifically for large, internationally active banks. The Agencies, however, elected to apply it to every bank in the country. The generic model has never been a good fit for the wide variety of individual circumstances of American banks, particularly the smaller institutions. Customization, we were told, was out of the question, since the rule was developed through international

collaboration. With multinational adoption of Basel II, the existing risk-based capital regime has become an archaic, idiosyncratic U.S. standard. In profound irony, it will be applied chiefly to the banks for which it was not intended, those that are not in the ranks of the largest or internationally active institutions. This misappropriation of capital standards needs to be addressed.

We congratulate the Agencies on their announced commitment to develop a revised version of the existing capital standards, sometimes called a Basel I-A. We compliment the Agencies on their plan to expedite the schedule for proposing alternatives to the Basel II capital rules so that they can be reviewed contemporaneously with the review of the current NPR. The mandatory banks have been working on their Basel II conforming systems for years. If the revised risk-based capital rules for all other banks are applied sequentially to the Basel II AIRB program, then the institutions adopting the AIRB standards will be ready to take advantage of their new paradigm while all others will be just beginning to adjust to theirs. These second-stage banks would, as an unintended result of regulatory action, surely lose customers and business to their larger rivals. Therefore, the Agencies need to move forward expeditiously to revise the general risk-based capital standards that will apply to banks not adopting the Basel II AIRB approach. This way the entire industry can be prepared to follow standards that are competitively comparable.

Moving up the existing risk-based capital standard revision schedule will also help with acceptance and implementation of Basel II. Accelerating the revision of the rule for the entire industry together would help allay competitive balance concerns voiced in the industry and by governmental leaders and reduce resistance to finalizing Basel II.

III. The variety and complexity of the American banking industry call for a select menu of capital options in order to achieve the best match of effective capital standard with banking institution; a one-size-fits-all approach means a bad fit for most banks.

Changes to the Proposal could make the AIRB approach a workable, effective means for determining how much capital is appropriate for the adopting banks. The ABA intends to submit detailed comments to the Agencies that will focus on changes we believe should be made to the “transitional floors,” to the continued application of the leverage ratio, to the definition of “default,” and to other areas where the regulators have taken what we consider to be unnecessarily restrictive positions. These changes would conform the AIRB for U.S. banks more closely to the AIRB as set forth in the international Basel II accord. If the problems highlighted during the comment period can be resolved, we would support adoption of the AIRB as one option for banks to consider.

In addition to addressing the problems in the AIRB approach, the Agencies should provide banks other appropriate risk-based capital options. This would include the Standardized Approach, as provided for in the Basel II accord. That approach ties capital charges to factors such as the credit rating of the borrower and the strength of collateral. It also recognizes that prudently underwritten residential real estate loans deserve a lower risk-weighting than is assigned under current rules.

While the Standardized Approach to credit risk is not as complex as the AIRB approach, it is nevertheless an improvement over existing rules and could be an optimal capital standard for many banks. For the mandatory banks it may be an appropriate balance of the benefits of greater risk sensitivity and the burdens of regulatory compliance. For banks considering whether to opt in to the Basel II framework, the Standardized Approach may present a better fit.

The Agencies also should continue their efforts to develop a “Basel I-A” approach that provides a meaningful option to the Standardized Approach. The current Basel I-A initiative was prompted by a recognition that existing capital rules are not sufficiently risk-sensitive for most banks but that the Basel II rules are likely to be too complicated. These concerns remain valid.

Many of the ideas discussed in the Agencies’ Advance Notice of Proposed Rulemaking (“ANPR”) concerning Basel I-A are potentially very helpful. These include such things as using more “risk buckets” when classifying assets and considering loan-to-value ratios when determining the capital charge for 1-4 family residential mortgage loans. However, given that no proposed rule has been published, it is impossible to offer views on particular changes to an existing regulation. If a Basel I-A proposal turns out to be largely the same as the Standardized Approach, we would encourage the Agencies to consider other options that would provide more flexibility when determining the appropriate amount of capital based on the quality of a bank’s systems.

A fourth option should be to retain Basel I standards for banks with uncomplicated balance sheets. For many banks of this nature, the supervisory and paperwork burden of adopting a new system, even if it could lower the capital requirement, would not be an efficient use of resources. Hence, the existing Basel I rule is a prudent standard for many banks and should be retained as an option.

It is important that risk and capital be appropriately linked for all banks regardless of their size, and in such a way as to avoid creating competitive disparities. However, the efforts to improve the risk sensitivity of regulatory capital requirements should not result in disproportionate compliance burdens. Applying a select menu of reasonable capital standards for banks of all sizes is the best course of action. Just as applying the AIRB standards to small banks with uncomplicated balance sheets would

result in a bad fit, so too would continuing to apply the existing Basel I program for large, internationally active banks. That principle holds true, as well, for banks in the middle. One-size-fits-all is likely to be a bad fit for most banks.

CRE GUIDANCE

I. Blanket Industry-wide CRE Guidance is Unnecessary and Potentially Harmful.

The Agencies have proposed guidance concerning commercial real estate concentrations that could have serious unintended and adverse consequences. By using blanket industry-wide guidance to address concentrations that the regulators are seeing at “some” banks, the regulators risk choking off the flow of credit from banks that are engaging in CRE lending in a safe, sound, and profitable manner.

The guidance has caused both confusion and concern. The confusion stems from several factors. First, the guidance has been proposed at a time when the banking industry is exceptionally healthy, as evidenced by recent reports from the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.¹ CRE loans in particular have performed exceptionally well, and have significantly outperformed commercial and industrial loans over the past decade.² Indeed, there is no indication that the guidance has been issued in response to widespread problems. In the preamble to the proposed guidance, the agencies note only that they are seeing concentrations at “some” banks. This does not warrant a conclusion that CRE concentrations are commonly found throughout the industry or even that they are *ipso facto* causing problems in the banks where the concentrations exist.

Second, there are significant differences between the banking industry of today and the industry of only a few years ago. For instance –

- Underwriting standards are better today, with more accurate appraisals, maximum loan-to-value ratios, and loan-to-one-borrower limits.
- The industry has significantly more capital today than before, and the regulators are statutorily directed to take forceful action when capital hits certain levels.
- Banks have better risk monitoring systems that catch problems quickly before they escalate.

¹ See, e.g., FDIC Quarterly Bank Profile for the Second Quarter of 2006 (<http://www2.fdic.gov/qbp/2006jun/qbp.pdf>); OTS Thrift Industry Highlights for the Second Quarter of 2006 (<http://www.ots.gov/docs/1/14620.pdf>).

² See FDIC Outlook for Summer of 2006 (http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer03.html).

- The combination of factors that led to the “perfect storm” that formed in the 1980s -- such as an oil market bust, very high interest rates, geographic concentration of bank assets, and a precipitous repeal of tax benefits -- is not present and has a low probability of repetition.

Third, the regulators have an ample supply of supervisory and enforcement tools at their disposal to address any bank that is failing to manage adequately the risks presented by a CRE concentration. This calls into question the need for industry-wide guidance. If, in fact, the regulators are seeing concentrations at only some banks, then the supervisory response should be tailored to fit the particular facts of a given bank.

Given the apparent absence of a problem that needs to be fixed, the ABA is concerned that the intent of guidance will be lost in its application. Examiners, eager to ensure that banks remain safe and sound and to avoid being second-guessed in the event problems arise in the banks they examine, understandably could construe an emphasis on CRE concentrations by Agency principals as a signal to crack down and direct a bank to take steps that are more conservative than the situation warrants. Indeed, some of our members have already experienced just that, as their examiners now appear to view concentrations as bad in and of themselves regardless of how well the concentrations are being managed.

There also is concern that the guidance is too blunt an instrument to address the particular issues affecting a given bank. The guidance uses a definition of “CRE loan” that is relatively new and, therefore, of undetermined value. However, by lumping many different types of loans together, the guidance fails to recognize that different types of CRE loans present different risks. For instance, a loan to build a multistory office complex will present very different risks from a loan to build 1-4 family homes. The guidance also fails to recognize that characteristics – and related risks – of loans within the same category will vary from loan to loan. Finally, the guidance does not account for the fact that resources vary from bank to bank and that risk mitigation steps that are used by one bank may be inappropriate for another.

These shortcomings have created concern that the guidance will make CRE lending too expensive for smaller banks to pursue. A burden that is not commensurate with risk will lead to inefficiencies that make this important line of business unprofitable for community banks. Banks will be forced to develop business outside their core competencies, thereby exposing the banks to risks for which they may be unprepared.

These problems are not confined to community banks. Even larger banks may find themselves being directed to put more aside in capital and reserves than safe and sound banking would otherwise

require. This could lead a bank either to underutilize the extra capital or use it in ways that increase the bank's risk profile as it tries to generate adequate returns on equity.

To avoid these outcomes, we have urged the regulators not to adopt the guidance but instead address problems on a case-by-case basis through the examination process and, if need be, enforcement actions. Clearly a bank with a CRE concentration needs to manage the risks of its CRE portfolio. Larger concentrations, of course, warrant greater attention. But a concentration in and of itself does not mean that greater care is not being given. The regulators already have every tool they need to address CRE concentrations where prudent care is not being given.

II. If the Agencies conclude that guidance on CRE concentrations is necessary, several changes should be made in order to avoid unintended negative consequences.

If the Agencies go forward with final guidance – which the ABA opposes – we have offered several suggestions for how to tailor the guidance better to the circumstances presented by today's banking industry. These suggestions are discussed in two letters the ABA has submitted on the proposed guidance, both of which are attached as appendices to this testimony.

Our suggestions highlight areas where the guidance needs to be refined to focus on concentrations more likely to be problematic. The broad and inclusive definition of CRE lending that is used in the proposed guidance is apt to lead to false alarms. The proposal focuses on sheer volume of loans secured by CRE without regard to mitigating factors, such as low loan-to-value ratios or guarantees. The guidance also lumps into the category of "CRE loans" business loans in which collateral interests in CRE are taken as additional security. By lumping so many different types of loans together, the guidance risks creating unfounded concerns that could adversely affect the supply and cost of credit.

III. The guidance, if applied, should be used as a tool to identify the need for further inquiry, not as a formula for increased capital and reserves.

If adopted in final form, the guidance should emphasize that it is not intended as a directive to require additional steps simply because a bank has a formulaic concentration. At most, it should be used as a tool identifying the need for further inquiry into the risk management practices of the bank. The examiners should consider requiring additional capital or reserves *only after* obtaining a full understanding

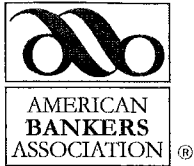
of the risks presented by a bank's portfolio and concluding that a bank is failing to manage those risks adequately.

The requested changes are consistent with the approach taken by the agencies in other contexts. For instance, the agencies stated in the Basel I-A ANPR that they “recognize that a ‘one size fits all’ approach to [acquisition, development and construction] lending might not be risk sensitive, and could discourage banking organizations from making ADC loans backed by substantial borrower equity.” The agencies noted that they are considering different approaches to the risk-weighting of CRE loans based on factors such as the amount of borrower equity in a given project and whether a loan meets the Interagency Real Estate Lending Standards. The Basel I-A ANPR discussion on CRE concludes with a request for comment on “alternative ways to make risk weights for commercial real estate loans more risk sensitive. To that end, [the agencies] request comments on what types of risk drivers, like LTV ratios or credit assessments, could be used to differentiate among the credit qualities of commercial real estate loans, and how the risk drivers could be used to determine risk weights.”³ The ABA agrees that this is a very important question to consider, but not just in the context of capital standards.

CONCLUSION

The initiatives to improve existing capital rules and to address CRE concentrations, while distinct in many respects, share at least two things in common. First, each initiative could impose burden that far outweighs its benefit. Second, alternatives exist that would strike a better balance between costs and benefits than do the proposals under consideration. We appreciate the Agencies' willingness to consider alternatives, and we remain committed to working with the Agencies toward the goal of keeping the banking industry a safe, sound, and vibrant provider of financial services.

³ ANPR, at 26-27.



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Re: **FDIC** (No docket ID); **FRB** Docket No. OP-1246; **OCC** Docket No. 05-21; **OTS** Docket No. 2006-01; **Proposed Interagency Guidance on Concentrations in Commercial Real Estate**; 71 Federal Register 2302; January 13, 2006.

Ladies and Gentlemen:

The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the "Agencies") have proposed an Interagency Guidance on Concentrations in Commercial Real Estate ("Guidance") that raises the requirements for risk management by banks and savings associations that are deemed to have a concentration in commercial real estate ("CRE"). While not all commercial banks or savings associations are significantly involved in commercial real estate lending, a large number of them -- including many community banks in particular -- are. For the reasons outlined below, this Guidance may well have significant adverse impact upon the banking industry and local economies. Accordingly, we recommend that the Agencies not issue it in its current form.

The American Bankers Association (ABA) appreciates the opportunity provided by the Agencies to comment upon the proposed Guidance. ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust

companies and savings banks--makes ABA the largest banking trade association in the country.

General Comments

ABA has been informed that Agency staff consider the Guidance as largely reflecting existing real estate lending guidance from the Agencies. However, ABA staff discussions with member bankers reveal that many of our bankers see the Guidance as imposing significant new requirements on them as they engage in CRE lending. These bankers see the Guidance as raising serious concerns, which may be summarized as follows:

1. The new definition of a concentration in CRE combines several different types of CRE lending and establishes triggers for additional action without any attempt to distinguish the different levels of risk posed by each. This results in too many banks being deemed to have a high risk concentration in CRE.
2. Bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe “concentration” of real estate loans. This is aggravated by confusing wording of the Guidance and the failure to reflect in the risk management practices differences in the size and CRE portfolios of different banks.
3. The Guidance strongly suggests that any bank deemed to have a concentration in CRE will be required to hold significantly higher levels of capital than other banks because of a conclusion that a large portfolio of CRE—as newly defined—is inherently riskier.
4. Similarly, the Guidance suggests that banks with large portfolios of CRE should have significantly higher reserves for loan losses. Such increased reserves should follow only if a portfolio in fact presents a higher level of risk.
5. The Guidance may significantly reduce community banks’ ability to fund CRE in their communities, which will have a negative impact on the banks and their communities.

Recommendations

The Agencies should not issue this one-size-fits-all Guidance. Rather, ABA recommends that instead of imposing these new costs on the industry in general, the Agencies apply existing guidance on a case-by-case basis to address any problems in those banks not engaging in CRE lending responsibly.

If the Agencies do issue additional CRE guidance, then ABA urges that the Guidance be modified. First, it needs to focus on those institutions that are causing concern for the Agencies, namely, those institutions with a genuine high-risk concentration in CRE. Therefore, ABA recommends that the Guidance should not apply to loans that are clearly not high risk. For example, the carve-out in the Guidance of “owner-occupied” loans should include loans where real estate serving as collateral is subject to a contract for the construction and purchase of the property and loans made directly to the eventual owner of the house, as these are significantly safer than speculative building.

Second, the initial concentration limits are too low to justify the greatly increased scrutiny. ABA recommends that the initial screen should be raised to at least 200% of a bank’s total capital.

Third, ABA recommends that the Guidance state more clearly how the specific requirements for management information systems and monitoring of the CRE portfolio may be scaled down for smaller banks and/or banks with narrowly focused CRE portfolios, such as primary residential housing construction.

Finally, ABA recommends that the proposed Guidance provide more detail concerning when higher levels of capital and/or of reserves would be required by examiners. The Agencies should not impute higher risk levels just on the basis of a finding of a concentration (as it is newly defined in the Guidance) in CRE lending but rather only on the basis of increased risk presented by the actual loans. It would be better if the Agencies addressed the needs for more capital or larger reserves on a case-by-case basis as part of the supervisory examination process rather than through an overly broad approach to reining in CRE lending. The finding of a concentration may suggest the need for closer review for risk but cannot replace the role of the supervisory examination process in identifying the actual presence of risks.

Analysis

1. Definition of a “concentration in commercial real estate lending”

Central to the application of the proposed Guidance is the definition of a “concentration in commercial real estate.” This raises two fundamental issues: First, what is a “commercial real estate loan”; and second, what level of CRE lending represents a “concentration”?

(a) The definition of CRE

CRE is defined by the Agencies as –

exposures secured by raw land, land development and construction (including 1–4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

CRE also includes loans to Real Estate Investment Trusts (REITs) and unsecured loans to developers that closely correlate to the inherent risk in CRE. The Agencies exclude loans secured by owner-occupied properties from the CRE definition as having a lower risk profile.

This definition¹ melds various loans secured by commercial real estate into essentially one risk bucket, which ignores the very different risk profiles of some types of CRE-secured loans. First, there is no differentiation between (a) retail and office commercial real estate loans and (b) 1-4 family residential construction loans. Construction loans for income property pose significantly higher risks than 1-4 family construction loans.² Second, there is no differentiation between 1-4 family residential

¹ The Guidance begins with the definition of CRE; however, the definition of CRE is only used in the second threshold of 300% of capital to reduce the amount of loans that count towards it by allowing deduction of loans reported in the Call Report or Thrift Financial Report that do not fit the special definition of CRE in the Guidance.

² ABA notes that the currently prescribed capital treatment of 1-4 family construction loans (50% vs. 100% risk weight of other loans) and the higher allowed supervisory loan to value limit (85% vs. 80%) is an acknowledgment by the Agencies of the lower relative risk of this type of lending. However, such recognition of this lower risk appears to be absent in the proposed Guidance. It would be appropriate to acknowledge this in whatever risk threshold is included in the final guidance. A failure to do so will distort risk level comparisons made between peer banks.

construction that is built “on speculation” from 1-4 family residential construction where the contractor already has a contract for the house (a custom home contract). Losses on custom home contracts are very low and should not be in the same risk category as “spec housing.”

The Guidance also inappropriately includes within the definition of CRE loans those loans that are made directly to consumers for construction of new housing. As we read the Guidance, the 100% threshold for a concentration of CRE does not treat these as owner-occupied. For some institutions, this type of lending is significant and its inclusion in regulatory guidance specific to CRE results in a significant distortion of the level of commercial construction risk relative to peer institutions. These direct-to-consumer construction loans are different from CRE because:

- These loans are generally originated for sale and underwritten to secondary market standards. The loans are classified as held for sale and generally sold to investors upon completion of construction.
- While there is construction completion risk, there is virtually no real estate market risk. The owner-occupants are responsible for repayment, and the loans are underwritten to permanent financing standards.
- Loans made directly to consumers are more appropriately considered consumer real estate loans instead of commercial real estate loans. The agencies acknowledge the lower risk in the former type of loan as the supervisory loan-to-value ratio limit for owner-occupied 1-4 family construction to permanent loans is 90%.

For all of these reasons, ABA recommends that the CRE definition be amended to distinguish clearly the risks between 1-4 family residential construction loans (particularly when they are “custom-built” loans or “owner-occupied” loans) and other commercial real estate loans. At a minimum, the Agencies should consider specifically excluding owner-occupied commercial real estate construction loans from the 100% threshold, in order to be consistent with the 300% threshold test for CRE, which acknowledges the fact that the risk profiles of these loans are less influenced by the condition of the general CRE market.³

(b) The appropriateness of the thresholds

The Guidance sets forth the following two supervisory thresholds, either of which may trigger greater scrutiny, greater risk management requirements, greater loan loss reserves, and greater capital:

(1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution’s total capital. Institutions exceeding threshold (1) would be deemed to have a concentration in CRE construction and development loans and should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance.⁴

(2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution’s total capital. Any institution exceeding threshold (2)

³ ABA notes that there are pending Call Report changes to schedule RC-C, line 1.e. that would facilitate the exclusion of owner-occupied commercial real estate loans from this calculation. If the Agencies continue with any Guidance, then ABA encourages the Agencies to use the new Call Report line item that excludes these loans when it becomes available.

⁴ As noted above, the overly-inclusive definition of CRE does not distinguish between levels of risk of different types of lending identified as CRE by the Call Reports. If the Agencies decide to issue a revised Guidance, then we suggest that there be changes to the Call Report that allow better differentiation before defining such a threshold.

should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices that are consistent with the Guidance.

Bankers are concerned about the relatively low threshold for determining when CRE concentrations present a higher risk. The Guidance sets an initial threshold of 100% of total capital for certain types of CRE. Previous limits on real estate lending set a threshold of 100% of total capital for loans secured by real estate **that were in excess of the supervisory loan-to-value ratio**. Total loans in excess of the supervisory LTV limits “for all commercial, agricultural, multifamily or other non-1-to-4 family residential properties” were also limited to no more than 30 percent of total capital.⁵ As we understand the proposed Guidance, it is now possible for an institution to have **no** real estate loans over their appropriate LTV, yet trigger a presumed level of higher risk in CRE lending. This appears to be a significant shift in supervisory concern not clearly justified by the Agencies.

2. The burden on banks to counter the assumption of an unsafe concentration of CRE

After determining that the bank has a concentration of CRE under the new thresholds, the bank must ensure that it has “heightened risk management practices that are consistent with the Guidance.” All of the bankers we have consulted agree that high levels of CRE require heightened risk management, and they believe that they do in fact have such risk management. However, few community banks have all of the revised recommendations for risk management practices in place, and none believes that all of the practices set forth in the Guidance are justified for the CRE lending that they are doing.⁶ These banks are following existing real estate lending guidance, rather than this

⁵ See FDIC regulations at Appendix A to 12 CFR Part 365: Interagency Guidelines for Real Estate Lending Policies.

⁶ The complete list of recommended risk management practices is extensive. It includes:

(1) Board and management oversight of the level of acceptable CRE exposures and implementation of a CRE strategy consistent with risk tolerance. “Directors, or a committee thereof, should explicitly approve the overall CRE lending strategy and policies of the institution. They should receive reports on changes in CRE market conditions and the institution’s CRE lending activity that identify the size, significance, and risks related to CRE concentrations. Directors should use this information to provide clear guidance to management regarding the level of CRE exposures acceptable to the institution.”

(2) Addressing the CRE strategy in the institution’s strategic plan. Strategic planning should include “an analysis of the potential effect of a downturn in real estate markets on both earnings and capital and a contingency plan for responding to adverse market conditions.”

(3) Instituting clear and measurable underwriting standards in its lending policy with only limited, documented, exceptions. Underwriting standards should include:

- Maximum loan amount by type of property,
- Loan terms,
- Pricing structures,
- LTV limits by property type,
- Requirements for feasibility studies and sensitivity analysis or stress-testing,
- Minimum requirements for initial investment and maintenance of hard equity by the borrower, and
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

(4) Instituting policies specifying requirements and criteria for risk rating CRE exposures, ongoing account monitoring, identifying loan impairment, and recognizing losses. Risk ratings should be risk sensitive, objective, and tailored to the CRE exposure types underwritten by the institution.

(5) Identifying and managing concentrations, performing market analysis, and stress testing CRE credit risk on a portfolio basis.

(6) Maintaining MIS systems that are adequate go provide, on either an automated or manual basis, stratification of the “portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. Institutions should be able to aggregate total exposure to a borrower including their credit exposure related to derivatives, such as interest rate swaps. MIS should maintain the appraised value at origination and subsequent valuations.”

proposed Guidance that requires more detailed risk management practices and is aimed at institutions that actually pose higher risks in their CRE lending. There appears to be no attempt in the proposed Guidance to scale the regulatory response to the size of the bank or the particular composition of its portfolio. This creates a “one size fits all” approach inconsistent with recent regulatory initiatives in examination and supervision. For example, in the recent ANPR on Modifications to Domestic Capital Standards (Basel IA), the Agencies suggest that it would be appropriate to lower further the risk weight of home mortgage lending. But this Guidance includes direct-to-consumer mortgage construction lending as higher-risk CRE.

The Agencies state in the preamble to the Guidance that

Recent examinations have indicated that the risk management practices and capital levels of **some** institutions are not keeping pace with their increasing CRE concentrations. In **some** cases, the Agencies have observed that institutions have rapidly expanded their CRE lending operations into new markets without establishing adequate control and reporting processes, including the preparation of market analyses.⁷

Thus, it appears that the proposed Guidance is meant to be focused on a few institutions. However, the way it is written suggests that examiners are to apply the Guidance with greater rigor to **all** institutions, not just the **some** that prompted the Agencies to propose the Guidance. We in fact already see this happening, as two of the bankers providing comment to ABA noted that their recent examinations involved much greater levels of scrutiny of the CRE and considerably more criticism of their risk management, even though neither felt that there had been significant changes in either their portfolios or their risk management practices since their last examinations.⁸

The extensive requirements set forth in the Guidance may be overwhelming for a community bank. Examiners will be asking for the bank’s reports on market conditions, evidence of increased board oversight, production of new policies, more detailed strategic planning, quantifiable limits, contingency plans, feasibility studies, sensitivity analysis, stress-testing, tracking presales and more. Examiners clearly may apply this Guidance in a way that substantially increases the regulatory burden on community banks with limited staffs, and they may well feel that they are required to do so by the terms of the Guidance. ABA and our bankers believe that the application of the Guidance to all banks is excessive and that the full array of measures it requires should be reserved for those few banks that have problems in the risk management of their portfolios, whether CRE or any other concentration of lending.

All of these burdens likely will be compounded by the Guidance being unclear in several places. For instance, it is not clear whether the different thresholds for determining CRE concentrations require different responses. Under threshold (1), an institution “should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance.” Under threshold (2), an institution “should have heightened risk management practices that are consistent with the Guidance.” The key appears to be that under threshold (1), an institution must determine its degree of CRE concentration risk and then apply appropriate risk management practices. This may allow institutions to determine that they have a lower risk rate in their portfolios of 1-4 family residential construction loans or in direct-to-consumer loans than if they have a concentration in office construction. However, the Guidance is not clear

⁷ 71 FR 2304 (emphasis added).

⁸ One of the bankers stated, after reading the proposed Guidance, that he now understood what had happened in his recently concluded exam: the examiners were applying the draft Guidance to his institution before it had been published.

that banks may do this. This may lead to a heightened but uneven examination scrutiny of banks' risk management practices, as different examiners arrive at different judgments of an institution's "degree of CRE concentration risk" and require significantly different levels of risk management practices to similarly situated institutions.

The organization of the Guidance adds to the confusion. First the Guidance gives a special definition of CRE. Then the Guidance gives two different thresholds for a concentration in commercial real estate lending based on Call Report (or TFR) items that do not use the special definition of CRE. Then it provides that for threshold (2), but not for threshold (1), bankers should examine their loans reported in the Call Report using the new definition of CRE to reduce the amount of loans included in threshold (2). This is backwards. The special definition of CRE should follow the explanations of the thresholds, and be clearly shown to apply only to the calculation of the final amount for the 300% threshold. We have noted significant confusion from this structure of the Guidance.

The Guidance excludes "owner-occupied" properties from the final calculation of threshold (2), but the Guidance does not define "owner-occupied" and neither do the Call Report instructions.⁹ This gives rise to a number of questions that will need to be resolved with the examiners. Is a loan to a contractor who is building the house under a contract for sale on completion "owner-occupied"? We believe it should be so termed. Are business premises that will be occupied by the owners but will also have commercial or even residential leases considered "owner-occupied"? Is it owner-occupied only if the owners occupy 25% or 50% or 75% or more of the building? Is it owner-occupied if the owners lease the premises to related companies of the owners? How closely do these companies need to be related to the owners in order for this to be owner-occupied? We believe that all of these questions could be answered in the affirmative, that these are still owner-occupied, but the Guidance is not clear on this.

ABA concludes that our bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe "concentration" of real estate loans. This is aggravated by confusing wording of the Guidance and the lack of scaling of the risk management practices required to banks of different sizes and different CRE portfolios. We believe that the net effect of the Guidance as it is currently written will be excessive burden on community banks.

3. Increased capital requirements

A concentration in any line of lending requires greater risk management as the concentration in the line increases. However, community bankers tend to focus on one or two major lines of lending in order to be sure that they have the expertise on hand to manage the risk in that lending. The Guidance would appear to have the effect of penalizing banks – by requiring capital at levels that may be inappropriately high – that have focused their resources precisely to ensure that they can compete in a safe and sound manner.

Higher levels of CRE lending appear to be a logical evolution for community banks. As former Federal Reserve Board Chairman Alan Greenspan said in a speech in early 2004,

⁹ An electronic search for the terms "owner-occupied" and "occupied" in the FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041) found on-line at http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_041_200509_i.pdf located no use of the term of "owner-occupied" or its definition.

Particularly noteworthy is the longer-term trend at community banks that seems to have accelerated in the past three years--the increasing share of asset growth accounted for by nonresidential real estate finance, particularly construction and land development loans and commercial and industrial real estate financing. Last year these categories accounted for more than 90 percent of the net asset growth of banks with less than \$1 billion in assets; multifamily real estate and farmland finance would bring the total to more than 100 percent, offsetting the declines in other categories.

Such credit exposures are a natural evolution of community banking and are quite profitable, helping to sustain both the earnings and growing equity capital of community banks. Moreover, the evidence suggests that community banks have avoided the underwriting mistakes that led to so many problems ten to fifteen years ago. Borrower equity is much higher and credit criteria are much stricter. In the last recession and during the early weak recovery, we saw very few delinquencies in these credits. Nonetheless, bankers need to be aware of the historical real estate cycle that, in the past, placed such exposures under severe stress. One hopes these improvements in underwriting standards are lasting. But the painful lessons of banking history underscore the ever-present need for vigilance in managing geographic and business line concentrations.¹⁰

Community bankers do not argue against the need for vigilance in managing geographic and business line concentrations. But they do argue against the arbitrary demand for additional capital that may result from the Guidance. Regardless of the intent of the Guidance, the risk is that the Guidance will lead to inappropriately higher capital levels. The Guidance states that –

Minimum levels of regulatory capital do not provide institutions with sufficient buffer to absorb unexpected losses arising from loan concentrations. Failure to maintain an appropriate cushion for concentrations is inconsistent with the Agencies' capital adequacy guidelines. Moreover, an institution with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures.¹¹

Our bankers unanimously read this as an instruction to examiners to demand more capital in the event that the examiner determines that there is a concentration in CRE. They see this as unrelated to how well the institution is managing its CRE portfolio, how low losses have been, what reserves have already been taken, and all of the other factors that should weigh on a determination of the need for additional capital. True, at the end of the discussion on capital adequacy, the Agencies state, "In assessing the adequacy of an institution's capital, the Agencies will take into account analysis provided by the institution as well as an evaluation of the level of inherent risk in the CRE portfolio and the quality of risk management based on the sound practices set forth in this Guidance." However, community bankers wonder if they can provide the kind of risk analysis that examiners will accept as mitigating this perceived higher risk. In short, bankers see this Guidance as a demand for higher capital at concentration levels that are really designed for triggering heightened risk management review rather than higher levels of capital.

¹⁰ Remarks by Federal Reserve Board Chairman Alan Greenspan before the Independent Community Bankers of America Convention; San Diego, California; March 17, 2004.

¹¹ 71 FR 2307.

The Agencies already have authority to demand higher levels of capital from any institution, if they determine that the institution has accumulated significantly higher risks than its peers or is otherwise acting in a manner that is inconsistent with existing guidelines.¹² Here the Guidance appears to move past that authority into creating an inherent need for additional capital for any concentration of CRE. Bankers believe that this sets far too low a trigger for requiring additional capital and ignores their current risk management practices. They urge that the Agencies drop this discussion of the need for additional capital and rely instead on existing authority, guidance and policies as the basis for a case-by-case determination of any need for additional capital.

4. Higher levels of reserves for loan losses

The Guidance appears to create a *per se* assumption that banks with large portfolios of CRE should have significantly higher reserves for loan losses because of a presumed greater level of risk presented by the CRE. However, many banks report little or no loss in their CRE portfolios, and they question the validity of singling out CRE for additional reserves. The Agencies, in the preamble to the Guidance, state that, “[i]n the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system.” But a point made repeatedly by bankers with whom we’ve communicated (and a point with which the Agencies apparently agree) is that banking today is different from what it was in the mid-eighties. We now have new capital requirements, more stringent real estate lending and appraisal requirements, express limits on high LTV real estate loans, and better supervisory examinations. As the Agencies note in the preamble, overall underwriting is better, largely due to the existing Agency guidance on real estate lending and the application of supervisory loan-to-value (LTV) ratios and limits on loans in excess of those ratios. Therefore, to blanket all banks with the requirements in the Guidance based on a newly crafted ratio, when there is no other evidence of weakness in capital or management, seems unjustified.

The assumption that there is a higher risk in a CRE portfolio ignores the risk presented by lending alternatives. Unsecured C&I loans, inventory financing, credit card lines, loans for consumer chattels -- none of these appear to be inherently less risky than CRE lending. Unlike these other types of loans, loans secured by mortgages on real estate will still have value in the property upon recovery even if the property deteriorates or the appraiser overestimated the property value. In even the worst case, only part of the principal will be lost.

By highlighting CRE and newly defining concentrations in CRE, the Agencies seem to be urging a higher reserving that previous guidance and policy do not appear to support. Worse, it may be at odds with recent guidance on reserving from the AICPA, which places the community bank squarely between its regulator and its auditors. At a minimum, this part of the Guidance needs to be clarified by better explanation of the connection of the Guidance to the existing Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.

5. Impact on small banks and their communities.

Finally, and most importantly, ABA is concerned about the probable impact of the proposed Guidance on small banks and their communities. Community bankers already find themselves unable to compete in various consumer lending businesses, lacking the scale to make credit card or auto lending profitable and sometimes unable to compete against the largest national mortgage

¹² See, e.g., Interagency Guidelines Establishing Standards for Safety and Soundness (stating that institutions should establish and maintain prudent credit underwriting practices that “(5) take adequate account of concentration of credit risk; and (6) are appropriate to the size of the institution and the nature and scope of its activities”).

lenders. Many have become larger lenders in the CRE market as a natural evolution of the banking market, as former Chairman Greenspan observed. This willingness to support business expansion in their communities has been crucial to economic recovery over the last few years throughout the nation.

The implication in the Guidance that there will be major increases in capital requirements and loan loss reserves, as well as major additional demands on banks' officers and lending personnel to provide in-depth market analysis, stress testing analysis, and other analyses relating to possible negative effects of CRE concentrations, leads many banks to believe that they may well have to curtail significantly their CRE lending. As CRE lending has been one of few remaining major profit lines for community banks, they are deeply concerned about the negative impact of this Guidance on them and, consequentially, on their communities.

Conclusion

As community banks have been forced to consolidate lending due to national competition (in credit cards, mortgage lending and auto lending, as examples), local commercial real estate has been one of the strongest products for community banks. Their knowledge of their communities and markets affords community banks a significant advantage when competing for CRE loans. To have now stricter guidelines regarding commercial real estate imposed on *all of them* appears to increase the costs to all community banks making CRE loans while only peripherally addressing any problem banks.

Our discussions with staff of the Agencies lead us to believe that those consequences are not the intent of the Agencies, but it is the nature of lending Guidance such as this to result in a period of constriction while examiners and bankers work out new understandings of the instructions they have been given. Such a result will not benefit community banks or their communities, and it apparently is not what the Agencies intend. ABA recommends that the Agencies carefully reconsider issuing this Guidance and instead rely upon current guidance and policies during examinations to rein in those few banks that are causing the Agencies' concerns about CRE lending.

If the Agencies continue with issuing this Guidance, ABA strongly urges the Agencies to revise the Guidance thoroughly to eliminate the areas of confusion and concern that it has created for banks. Failing to do so would be a disservice to the Agencies' regulated institutions and to the communities these banks serve. If you have any questions about these comments, please call the undersigned.

Sincerely,

A handwritten signature in black ink that reads "Paul Alan Smith". The signature is written in a cursive, flowing style.

Paul Smith
Senior Counsel



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August 1, 2006

The Honorable Susan Schmidt Bies
Governor
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Re: Summary of Suggested Improvements to the Guidance on Concentrations in
Commercial Real Estate (CRE), July 20 Meeting

Dear Governor Bies:

Thank you again for your participation in the recent meeting to discuss the proposed CRE guidance. Our members agreed with your assessments that the meeting was very productive, and we appreciate the opportunity to discuss the industry's concerns about the guidance. Following that meeting, we were offered the opportunity to summarize the suggestions offered at the meeting for ways to improve the guidance. Below is a summary of the major points advanced as well as other points that supplement the American Bankers Association's (ABA) comment letter dated March 30, 2006.

We note at the outset our continuing belief that it is more appropriate for the agencies to address problems with CRE concentrations on a bank-by-bank basis rather than issue a document that, because it applies industry-wide, necessarily risks being applied inappropriately at some institutions. If an examiner determines that a bank is failing to manage its CRE risks adequately, then clearly the agency should work with the bank to ensure that deficiencies are corrected. This is different, however, from suggesting (as guidance inevitably does) that there is a problem across the entire industry that the examiners must now fix. The latter approach risks inappropriately severe and procrustean responses by examiners to problems that do not exist.

If, however, the agencies conclude that guidance is necessary notwithstanding that risk, we offer the following suggestions for improvements to the guidance.

1. Of gravest concern to our bankers is the belief that the guidance may be interpreted as a direction to examiners, once a CRE concentration in the bank's portfolio of loans is found, to require a bank to take additional steps (perhaps including adding capital or refraining from making additional CRE loans), even if that portfolio is well managed. Subsequent discussions with the principals and senior staff of the Agencies reveal that this was not the intent of the Guidance. Our first suggestion, therefore, is to clarify in the guidance that CRE loans are not inherently riskier than other types of loans and that, if prudently managed, a bank may continue to make CRE loans notwithstanding the fact that the bank has a CRE concentration.

2. Related to the first point is a concern about the guidance being applied in a way that would automatically result in the imposition of additional CRE risk-monitoring or risk-mitigation steps, including additional capital and/or reserves for loan or lease losses. As discussed at our meeting, our members strongly believe that no regulatory response should be forthcoming without an adequate understanding by the examiners of how well a particular bank is managing its CRE portfolio. To impose additional burden on a bank without first determining that the bank is not properly managing the CRE portfolio is to a troubling degree like shooting in the dark and could be unnecessary, counterproductive, and harmful to the bank and its community. Thus, the guidance must underscore that any supervisory response will be calibrated to the facts presented by a particular bank.

3. The guidance must also reflect the fact that different banks have different resources and that what will be appropriate for one bank may be inappropriate for another. A community bank cannot be expected to have the systems, people, and processes that a regional or multinational bank has and may not need them for its particular situation and conditions. We appreciate acknowledgement of this fact in recent speeches by the agency principals,¹ and we urge that the final guidance contain a comparable acknowledgment.

4. Specifically in the context of the discussion of capital and reserves, the guidance should state that capital and reserves are appropriate topics for discussion only after the following:

- A concentration is found;
- The risk of the CRE portfolio is determined;
- Examiners conclude that the risk is not adequately managed;
- Examiners inform management of the inadequacies;
- The bank does not take steps to improve risk management within a reasonable time; and
- Examiners then determine that current reserves and/or capital are inadequate for the risk.

Requiring a bank to add capital and reserves in the absence of a demonstrated need either will adversely and inappropriately affect return on equity or force the bank to take additional risks, perhaps outside its area of expertise, in order to make efficient use of the additional funds. This could lead to more risk being driven into the banking system by the very requirement (*i.e.*, additional capital) that is intended to strengthen the industry.

5. The definition of “commercial real estate” for purposes of any final guidance should be rewritten. Currently, out of 44 pages of the Call Report, two-thirds of a bank’s assets are lumped together on one line on Schedule RC-C. As discussed below, this raises concerns about the utility of the current definition and the need to narrow the definition of CRE loans.

Utility of the definition. The proposed guidance includes so many different types of loans within the definition “CRE” lending that it undermines whatever utility there is to identifying a concentration. The current approach includes residential construction, office construction, business expansion, and small business loans secured by real estate, all of which may exhibit considerable variability in risk, loan-to-value (“LTV”) ratios, and market volatility. It is difficult to draw meaningful conclusions about the risks of a concentration when so many different types of loans –

¹ See, *e.g.*, Remarks by Governor Susan Schmidt Bies at the Mortgage Bankers Association Presidents Conference, June 14, 2006.

sharing only the common thread of being secured in whole or in part by commercial real estate – are lumped together. While the proposed changes to the Call Report² will partially help address this issue by providing additional granularity that may be used to identify problematic concentrations, until those changes are finalized the guidance is likely to create “false positives” where examiners conclude that a bank has greater risk from its CRE portfolio than the facts support.

Scope of definition. Even after the Call Report changes are finalized, the proposed definition of “CRE loan” inappropriately includes certain types of loans. This can be addressed only through changes to the definition. At a minimum, bankers believe that a definition of CRE for determining a concentration should exclude:

- Residential construction loans to consumers, which are risk-weighted at 50% for capital;
- Loans to builders on presold homes;
- Construction loans to entities that will occupy the building once it is completed;
- All 1-4 family residential rental property loans; and
- Loans with a low LTV ratio.

It may be possible to use a broad definition of CRE while taking the above CRE distinctions better into account in the risk assessment of the portfolio. That is, rather than exclude these types of CRE from the definition, simply provide guidance to examiners that these types of CRE may pose considerably less risk and will require less rigorous “risk management” because of the lower risk inherent in them. This appears to be particularly true of loans to consumers for 1-4 family residential construction, presold residential construction, and loans with LTV ratios of 50% or less. Indeed, as noted above, 1-4 family residential construction loans are viewed as such low-risk investments that they are risk-weighted under Basel I Capital Accord at only 50% and may be rated even lower in Basel II revisions to the Capital Accord.

6. The proposed guidance excludes “owner-occupied” property, but bankers found the definition of “owner-occupied” to be unclear. We note that the recent FDIC FIL-7-2006 contains a test for determining whether a property is “owner-occupied.”³ At a minimum, this explanation should be included in the guidance.

² Several proposed changes to the Call Reports have been adopted, but on a staggered, delayed system, some in 2006, some in 2007, and some in 2008, largely dependent upon the size of the bank and the degree of concentration in CRE. The changes are as follows:

- Splitting “Construction, land development, and other land loans” (CLD&OL loans) into separate categories for 1–4 family residential CLD&OL loans and all other CLD&OL loans (Schedule RC–C, part I, item 1.a; Schedule RC–N, item 1.a; Schedule RI–B, part I, item 1.a; and Schedule RC–L, item 1.c.1);
- Splitting loans “Secured by nonfarm nonresidential properties” (commercial real estate loans) into separate categories for owner-occupied and other commercial real estate (Schedule RC–C, part I, item 1.e; Schedule RC–N, item 1.e; Schedule RI–B, part I, item 1.e); and
- Replacing the breakdown of “Lease financing receivables” between leases from U.S. and non-U.S. addressees with a breakdown of leases between retail (consumer) leases and commercial leases for banks with foreign offices or with domestic offices only and \$300 million or more in total assets (Schedule RC–C, part I, items 10.a and 10.b; Schedule RC–N, items 8.a and 8.b on the FFIEC 031 and Memorandum item 3.d on the FFIEC 041; and Schedule RI–B, part I, items 8.a and 8.b on the FFIEC 031 and Memorandum item 2.d on the FFIEC 041).

³ “Loans secured by other nonfarm nonresidential properties” are those loans that are currently reported in Schedule RC–C, item 1.e, where the primary or a significant source of repayment is derived from rental income associated with the property (i.e., loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

7. The guidance also needs to provide a clearer discussion of what agricultural loans are included within its scope. The proposed guidance has two concentration tests:

- (1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital; or
- (2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital.

The proposed guidance states in the footnotes that item (1) above is "For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C item 1a." The Call Report instructions state that:

Schedule 1.a Construction, land development, and other land loans. Report in column B loans secured by real estate made to finance land development (i.e., the process of improving land -- laying sewers, water pipes, etc.) preparatory to erecting new structures or the on-site construction of industrial, commercial, residential, or farm buildings. For this item, "construction" includes not only construction of new structures, but also additions or alterations to existing structures and the demolition of existing structures to make way for new structures.

Also include in this item:

- (1) Loans secured by vacant land, except land known to be used or usable for agricultural purposes, such as crop and livestock production (which should be reported in Schedule RC-C, part I, item 1.b, below, as loans secured by farmland).... (Emphasis added.)

For the second test of a CRE concentration, the proposed guidance includes nonfarm nonresidential properties, as reported in the Call Report. This point is explained in footnote 4 of the proposed guidance as follows: "For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C items 1a, 1d, and 1e." 1b is loans secured by farmland and 1c is loans secured by 1-4 family residential properties.

The guidance leaves open questions such as whether a loan secured by land on which a farm building is constructed is included within the definition of "CRE loan" and, if so, whether it is included for purposes of both concentration thresholds. In order to achieve the agencies' goal of providing clarity about what is a CRE concentration, and in order to avoid any unintended consequences of discouraging farmland lending, the guidance must be clearer in its discussion of when farmland will be deemed to be within the scope of the guidance.

Thus, the primary or a significant source of repayment for 'Loans secured by owner-occupied nonfarm nonresidential properties' is the cash flow from the ongoing operations and activities conducted by the party, or an affiliate of the party, who owns the property, rather than from third party, nonaffiliated, rental income or the proceeds of the sale, refinancing, or permanent financing of the property. 'The determination as to whether a property is considered 'owner-occupied' should be made upon acquisition (origination or purchase) of the loan. However, for purposes of determining whether existing nonfarm nonresidential real estate loans should be reported as 'owner-occupied' beginning March 31, 2007, or 2008, banks may consider the source of repayment either when the loan was acquired or based on the most recent available information. Once a bank determines whether a loan should be reported as 'owner-occupied' or not, this determination need not be reviewed thereafter." (Emphasis added.)

* * *

As noted at our meeting, we very much appreciate the agencies' willingness to discuss the concerns of the industry and to make appropriate adjustments to the guidance to reflect those concerns. If the agencies decide that guidance is necessary (as opposed to dealing with problems on a case-by-case basis), then, given the substantial changes to the guidance that we recommend be made, we suggest the agencies republish the guidance in proposed form again so that the final product is likelier to strike the appropriate balance between benefit and burden. If, however, the agencies decide to publish a final guidance document as the next step, we suggest at a minimum, given the nonbinding, informal nature of guidance, that the agencies continue their dialogue with the industry about how the guidance is being applied and ways it may be improved going forward.

Sincerely,

Mark Tenhundfeld
Director, Office of Regulatory Policy

CC: Steve Fritts
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